MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 045 // **November 22, 2021**

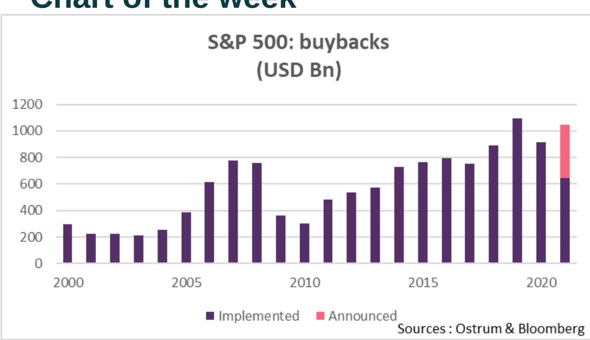
Topic of the week: Tensions on the Irish protocol: Return of the risk of hard Brexit ?

- **Less than a year after Brexit took effect, UK calls for a reform of the Irish protocol ;**
- **If talks with EU fail, UK threatens to trigger Article 16, lifting certain provisions of the protocol ;**
- **The EU is preparing retaliatory measures in this eventuality, including the suspension of the free trade agreement ;**
- **Therefore, the risk of a hard Brexit is back. If tensions escalate, uncertainty will weigh on UK growth and lead to higher volatility of the pound.**

Market review: Renewed sanitary angst

- **Covid cases up sharply in Europe;**
- **Late pullback in European equities;**
- **Bunds dip back below -0.30%;**
- **The euro weakens further under $1.13.**

Chart of the week



The share buybacks on the S&P have amounted to $642 billion over the first 10 months of the year. But if we add the announcements, the level exceeds 1,000 billion for this year!

With margins returning to historical highs, cash flows are also very high and US companies have decided to return much of this cash to their shareholders. This is a major support element for equity markets.

Figure of the week

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Source : Ostrum AM

The number of lockdown days announced in Austria. The renewed spread of the pandemic is worrying and has already begun to destabilize markets.

Stéphane Déo
Head of markets strategy
stephane.deo@ostrum.com

Axel Botte
Global strategist
axel.botte@ostrum.com

Zouhoure Bousbih
Emerging countries strategist
zouhoure.bousbih@ostrum.com

Aline Goupil- Raguénès
Developed countries strategist
aline.goupil-raguenes@ostrum.com

Topic of the week

Tensions on the Irish protocol: Return of the risk of hard Brexit?

Less than a year after Brexit took effect, tensions between the UK and the EU have escalated. The reason: the UK is calling for a reform of the Irish protocol, a key part of the divorce agreement. Certain demands of the British government are irreconcilable with the rules of the European Union. Faced with the deadlock in negotiations with the EU for a month, the UK is threatening to trigger Article 16 of the Irish Protocol, and remove some provisions. The EU is preparing retaliatory measures in this event, which could extend to the possibility of suspending the trade agreement. The risk of a hard Brexit is therefore once again topical. While the latest talks look encouraging, the UK threat to trigger Article 16 persists. This creates uncertainty that may further weigh on UK growth and lead to higher volatility in the pound.

Why is the Irish protocol at the center of tensions?

What is the Irish protocol?

The Irish question was THE sticking point between the UK and the EU in negotiations to determine the conditions for UK exit. In order to preserve the Good Friday Agreements of 1998, which ended 30 years of violence, a way had to be found to ensure free movement between Northern Ireland, part of the United Kingdom, and the Republic of Ireland, a member of the European Union, once Brexit is effective. To this end, the UK and the EU have agreed to put in place a specific mechanism: the Protocol on Ireland and Northern Ireland.

To avoid the emergence of a physical border, it was decided that Northern Ireland remains in the customs union and the single European market for trade in goods. As a result, customs controls now take place on goods in transit between Great Britain and Northern Ireland, in the Irish Sea. As it is part of the single European market for trade in goods, it must also comply with a number of European rules and regulations. The European Court of Justice is also responsible for ensuring the proper application of the Protocol in Northern Ireland.

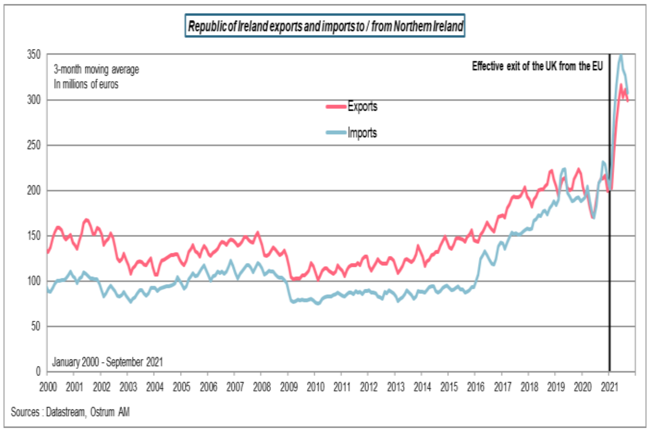
Difficulties in implementing the Irish protocol

Since its entry into force on February 1, 2021, trade disruptions have occurred in trade between Great Britain and Northern Ireland due in part to the short time for the authorities to put the protocol in place. Added to this were the disruptions linked to the Covid-19 epidemic.

This has resulted in shortages of certain goods in Northern Ireland, more specifically of fresh food products, even though all the control were not yet in place to ensure a gradual implementation of the scheme. This is still not the case, the European Union having decided to extend the grace period for the trade of certain products (frozen meat and medicines in particular). These controls were initially unilaterally lifted by the UK.

These disruptions were to be expected. This is the direct consequence of the Brexit wanted by the UK and of the Irish protocol negotiated with the EU so as not to weaken the Good Friday peace agreements. By exiting the EU and the single market, the UK has ended the free movement of goods, people and capital with the EU. Under the Irish Protocol, in order for goods to circulate freely in Ireland, those transiting from Great Britain to Northern Ireland must be subject to control in the Irish Sea (checks of administrative forms and sanitary and phytosanitary controls) which restricts trade within the United Kingdom.

Data on trade between Northern Ireland and Great Britain have not been available since the start of the year. However, there has been a dramatic increase in trade between Northern Ireland and the Republic of Ireland since January 1st, 2021, as shown in the graph below. The Republic of Ireland's exports to Northern Ireland have increased by 50% since the start of the year and imports by 44%. Northern Ireland thus tends to benefit from the best of both worlds as it is part of both the single European market for trade in goods and the UK market. However, these figures suggest less trade between Northern Ireland and Great Britain due to the many administrative formalities to be completed.



The establishment of the Irish protocol also rekindled tensions among Unionists who did not accept this difference in treatment with the rest of the United Kingdom and saw it as a territorial threat.

UK government threatens to trigger Article 16 of Irish Protocol

On July 21, 2021, the UK government released a document claiming that the implementation of the Irish Protocol was having a significant economic, political, social and trade impact and was causing a shift in trade. According to the latter, it is clear that this device cannot be applied in a lasting way, at least within the rigid framework wanted by the EU.

The difficulties are such that it would justify triggering safeguard actions under Article 16 of the Irish Protocol.

What is Article 16 of the Irish Protocol?

Article 16 allows one of the two parties to unilaterally take "safeguard measures" if the application of the Irish Protocol causes "serious economic, societal or environmental difficulties which are likely to persist or a reorientation of trade". These safeguard measures must be appropriate and "limited in their scope and duration to what is strictly necessary to remedy the situation". If these create an imbalance in the application of the Protocol, the other party may take proportionate measures to remedy them.

The United Kingdom considers that the current situation justifies the triggering of Article 16 and wishes to suspend certain provisions of the Irish Protocol unilaterally. However, it initially leaves room for negotiations with the EU to "find a new balance" on the implementation of the protocol.

UK wants to renegotiate Irish protocol

To this end, the UK government has made proposals to radically change the protocol by calling for a renegotiation of several key elements. In particular, it wants to remove all controls on goods in transit between Great Britain and Northern Ireland, except when the shipper self-certifies that these are destined for the European Union. He also wants to authorize the circulation of goods respecting only British standards. He also wants to end the authority of the European Court of Justice in Northern Ireland in the context of the application of the protocol. He also wishes to come back to the rules concerning subsidies.

EU proposes to relax the application of the protocol without reforming it

After ruling out a renegotiation of the protocol, the European Union proposed, on October 13, measures aimed at making its implementation more flexible and thus facilitating trade between Great Britain and Northern Ireland for goods not destined for the EU.

The European Commission has therefore proposed to reduce customs formalities on goods by 50% and to reduce sanitary and phytosanitary controls on food and plant products by 80%. In return, the United Kingdom will notably have to issue guarantees showing that these products are intended only for sale in Northern Ireland and safeguards must be put in place. The EU is also proposing a solution to secure the long-term supply of medicines to Northern Ireland from Britain.

Recent progress in UK-EU talks

The measures proposed by the EU were considered insufficient by the United Kingdom since on the one hand not all goods are affected by this relaxation and nothing particularly concerns the issue of the European Court of Justice or subsidies.

Discussions have been going on for 5 weeks. As tensions escalated in the first four weeks, talks appear to have progressed last Friday (November 19). Minister of State Michael Gove, previously in charge of negotiating Brexit, said he was confident that the UK-EU dispute would be resolved without triggering Article 16.

David Frost, Minister responsible for Brexit, said that while progress had been made in recent discussions, significant gaps remained that could justify the triggering of Article 16. On the other side of the Channel, the Vice President from the European Commission, Maros Sefcovic, also noted the more constructive tone of the latest discussions while urging the UK to adopt measures aimed at fully establishing sanitary and phytosanitary controls in return for the proposals made by the EU.

While tensions appear to be easing as the end of the year approaches, the UK threat to trigger Article 16 persists and it cannot be ruled out that tensions will once again intensify, particularly over the issue of authority of the European Court of Justice in Northern Ireland questioned by the United Kingdom.

What will happen if the UK triggers Article 16?

Once the UK has notified the EU of its intention to trigger Article 16, the two sides will immediately enter into consultations to find a mutually acceptable solution. The UK will only be able to adopt safeguard measures after a period of one month following notification, except in exceptional circumstances requiring immediate action.

If these measures are not considered appropriate and create an imbalance in the application of the Protocol, the EU may adopt measures to remedy them. Everything will depend on those taken by the UK. This can include the implementation of more sanitary and phytosanitary controls, an increase in certain tariffs or go well beyond depending on the measures taken by the UK.

Return of the risk of hard Brexit?

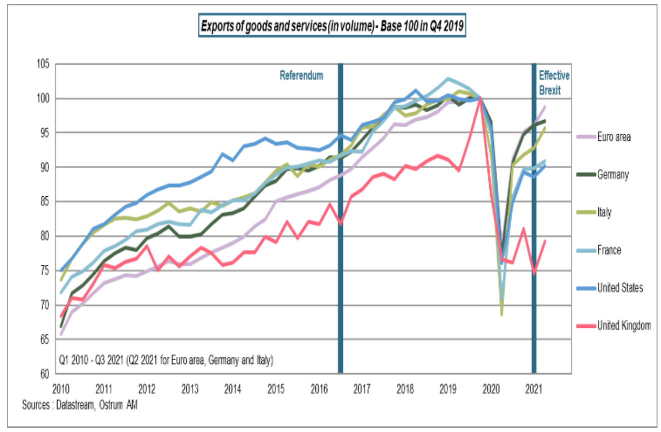
If the UK suspends key provisions of the Irish Protocol, if not all, the EU will have no choice but to take radical action. Irish Foreign Minister Simon Coveney has indicated that the UK-EU free trade agreement could be suspended. This Trade and Cooperation Agreement, signed on December 30, 2020, avoids the imposition of tariffs on goods moving between the UK and the EU. Suspending it would mean following the rules of the World Trade Organization (WTO) after a year with the introduction of tariffs on trade in goods between the EU and the UK. So it would be a Brexit without a trade deal, that is, a hard Brexit. These statements by EU members are most likely at the origin of the more conciliatory tone of the British since this weekend.

Indeed, the divorce agreement between the UK and the EU, including the Irish protocol, was a prerequisite for starting discussions on their future trade relations. The free trade agreement and the divorce agreement are therefore intrinsically linked, the suspension of the protocol by the UK resulting in the suspension of the trade agreement by the EU.

What are the consequences of Brexit?

A hard Brexit, that is to say without a trade agreement between the EU and the UK, would have the consequence of weighing more heavily on British growth. Trade in goods, in addition to being subject to non-tariff measures as currently (customs, sanitary and phytosanitary controls), would also be subject to the establishment of customs tariffs.

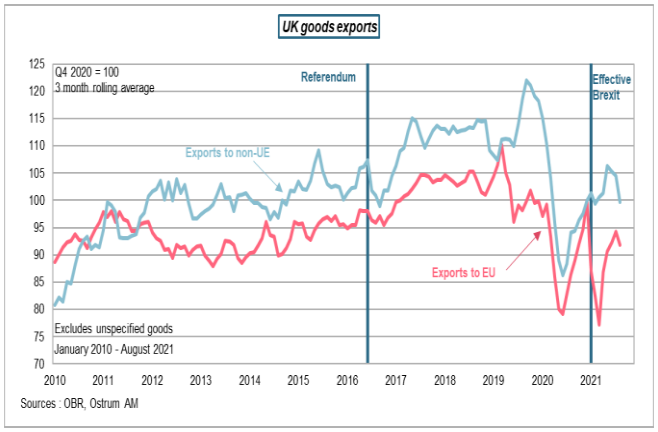
It is clear from the graph below that Brexit is having major consequences for the UK economy.



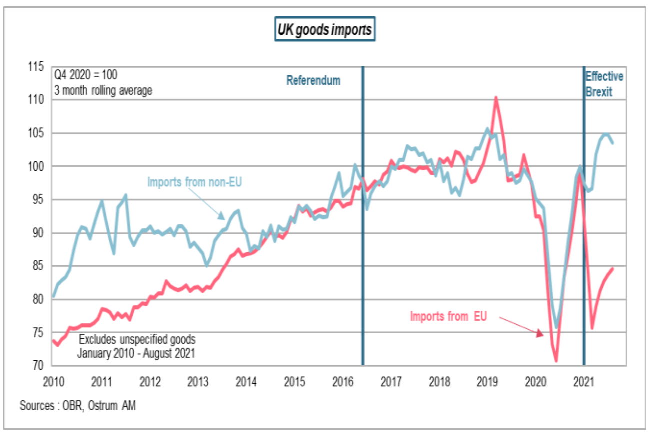
Exports of goods and services (in volume) plunged in all countries at the start of 2020 due to the shock linked to the Covid 19 pandemic. But in the recovery phase, linked to the lifting of restrictions health, vaccination campaigns and major measures taken by governments and central banks, the UK is struggling. Exports remain a little over 20% below the pre-crisis level while they have rebounded sharply in the Euro zone, Italy, France, Germany and the United States to approach the pre-crisis level.

In addition to the shock of the pandemic, the UK has also suffered the shock of Brexit. While the free trade agreement avoids tariffs, it slows down the flow of goods due to the necessary controls. Furthermore, no provision has been made for trade in services, and in particular financial services, which represents a significant part of UK growth. In addition, by ending the free movement of people, Brexit has accentuated the labor shortages caused by the Covid 19 crisis. This particularly concerns truck drivers, constituting an additional brake on trade.

If we look more closely at the trade in goods between the European Union and the UK, we see that UK exports to the EU are less dynamic than those to the rest of the world. After falling early in the year following Brexit, they rebounded to remain well below the level before the end of the transition period.

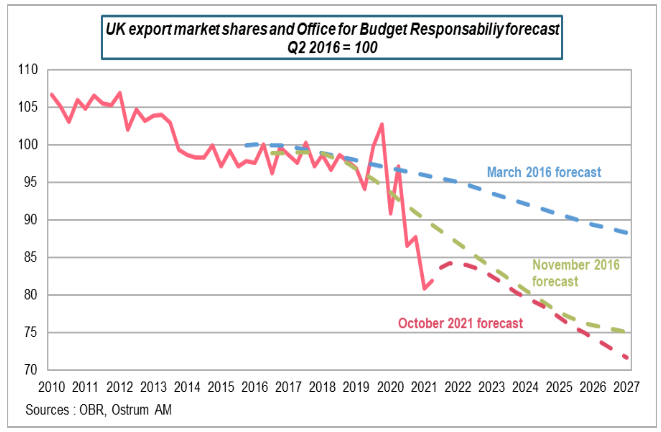


The difference is spectacular for imports. Those from the EU fell at the start of the year and remain, in August, still 15% below the level of Q4 2020, while those from the rest of the world have increased to be at the end of August almost 5% above the Q4 2020 level. This attests to the disruptions linked to Brexit.



The Center for European Reform has made estimates of the impact of Brexit by isolating it from that of the Covid-19 crisis. The results show that Brexit weighed on trade in goods by 15.8% in August 2021 compared to December 2020.

This first available data has led the Office for Budget Responsibility (OBR) to confirm its estimates of the long-term impact of Brexit. They are represented in the graph below. UK exports have lost significant market share since the Brexit referendum, due to an effect of uncertainty and anticipation. This will continue with the full implementation of the trade and cooperation agreement, with some measures partly pending, and the adjustment of the behavior of entrepreneurs to these new conditions. This leads OBR to confirm its estimate of a 15% long-term decline in UK total exports and imports compared to the situation where it would have remained in the EU. This also confirms its estimate of the impact of Brexit on UK long-term growth of -4%.



Impact of a hard Brexit on the economy

In the event of a hard Brexit, the OBR estimates a stronger impact linked to the increase in tariffs. Growth would be 6% lower compared to a situation without Brexit. In the short term, GDP would contract by an additional 2%.

Without a trade agreement, trade will be subject to WTO rules, which will result in higher tariffs and non-tariff barriers. This will particularly affect sectors that have been relatively less affected by the Covid-19 crisis. In addition to the rise in customs tariffs, the pound will depreciate sharply, which will result in higher inflation likely to weigh on the purchasing power of households. In the long term, potential growth will be affected by lower productivity, linked to lower foreign direct investment and lower trade, and lower growth in the working population, resulting from lower migratory flows from the EU.

The threat of triggering Article 16 alone can weigh on growth

This generates uncertainty that can weigh on the behavior of entrepreneurs and households. Before Brexit took place, entrepreneurs became more cautious, unsure of what form the UK's exit would take. This was reflected in particular in a much lower dynamic of productive investment relative to other countries. If the threat from the UK intensifies, the risk is to weigh on activity and investment without even having to trigger Article 16.

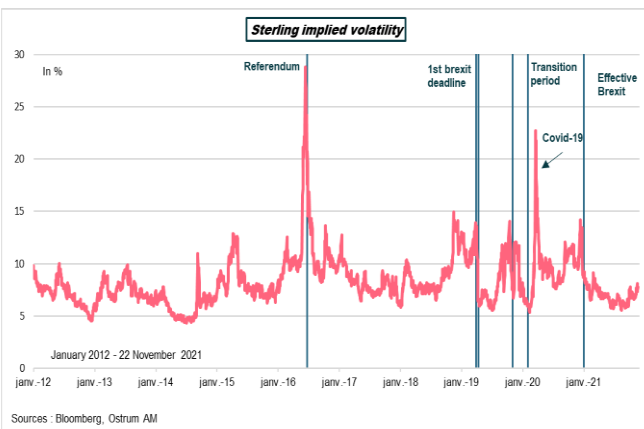
Loss of trust

The United Kingdom's request to significantly modify the Irish protocol, part of the withdrawal agreement negotiated with the European Union in October 2019 and presented at the time by the Prime Minister, Boris Johnson, as a "great treaty", is likely to further weaken the trust between London and Brussels. Disruption in trade between Britain and Northern Ireland was inevitable. By calling for protocol reform and brandishing the threat of triggering Article 16, Boris Johnson opts for a confrontation with the European Union, his biggest trading partner. The risk is that the British government may never have intended to apply the Irish protocol.

Consequences for financial markets

Volatility of sterling

If the threat from the UK to trigger Article 16 of the Irish Protocol becomes more significant, it will have consequences for the financial markets and first and foremost the foreign exchange market. This will result in higher volatility of sterling. During the referendum, it had crystallized the fears of investors by literally plunging. Volatility also increased at the end of March 2019, the 1st UK exit deadline and the following two. After another peak in March 2020, following the health crisis, volatility rose again in December 2020, with the UK and EU waiting until the last moment to agree on the free trade agreement.

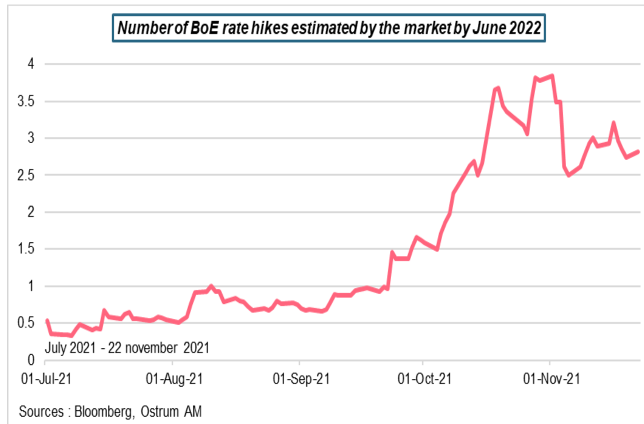


Volatility has increased slightly since the end of September. This comes from the conclusions of the Bank of England meeting on September 23, which hinted at a faster-than-expected normalization of monetary policy.

If tensions rise between the UK and the EU to the point of suggesting an imminent outbreak of Article 16, volatility will increase. It will be all the stronger as the safeguard measures taken by the UK are important. This would spark anticipation of far-reaching retaliatory measures by the EU with the risk of a hard Brexit returning.

Bank of England monetary policy

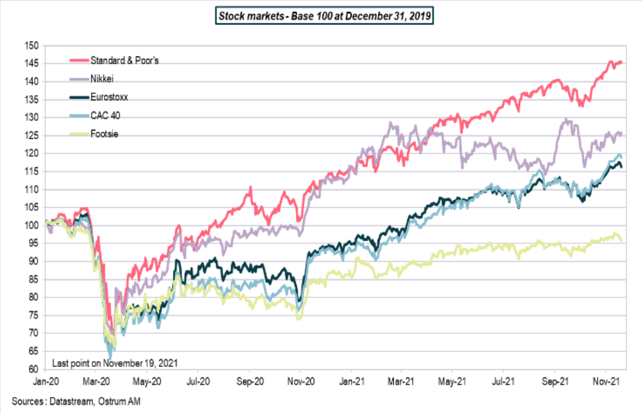
Markets have sharply revised upwards the rate hike expectations from the Bank of England (BoE) since the September 23 meeting, after which 2 out of 9 members voted to end the program purchases of financial assets. These expectations continued to rise in October with "hawkish" statements from some BoE members, chief among them Governor Andrew Bailey, that a rate hike would be imminent. If the Bank of England preferred to pass its turn on November 2, reducing market expectations a little, they continue to forecast a rapid normalization of monetary policy to cope with the acceleration of inflation.



If threats from the UK become more pressing about the triggering of Article 16, causing uncertainty to rise and the pound to fall, the Bank of England will be in a dilemma. On the one hand, the risks to growth should lead it to adopt a more cautious stance, prompting it to wait before raising its rates. On the other hand, the depreciation of the pound will translate into a rise in the price of imported goods which can increase inflationary pressures and may encourage it to raise its rates.

Consequences on stock markets

While all stock market indices plunged between the end of February and mid-March 2020, due to the shock linked to the Covid 19 crisis and the adoption of strict containment measures almost simultaneously throughout countries, the rebound phase was very different depending on the country. The American S&P index is well ahead, followed by the Japanese Nikkei index then the Eurostoxx 50 and the CAC 40. The British Footsie 100 index has however still not recovered to the pre-crisis level: - 4% compared to December 31, 2019, compared to + 45% for the S&P and + 16% for the Eurostoxx. The UK has not only been the economy of developed countries most affected by the Covid 19 crisis, but has also had to deal with Brexit at the same time. This has in particular accentuated the shortages of certain goods, especially fresh produce, and of labor.



If Article 16 is triggered, again the impact on equity markets will depend on UK action and EU response. The larger they are, the higher the risks to growth. This will therefore weigh on the earnings outlook for companies most heavily dependent on the internal market. The Footsie 250 index, which better reflects the situation of the domestic market, will therefore be more affected. On the other hand, the fall in the pound will translate into competitiveness gains for exporting companies, which represent a significant proportion of the Footsie 100 index. The Footsie 100 and Footsie 250 indices could thus experience contrasting trends.

Conclusion

While the latest talks between the UK and the EU seem encouraging, the threat of triggering Article 16 of the Irish Protocol is still present and with it the risk of a hard Brexit. If this risk persists and increases, the greater uncertainty should lead business leaders to adopt a more cautious behavior in terms of investments and hiring. Tensions between the UK and the EU are likely to escalate again, heightening the risk that the UK will eventually take action. This will have consequences for UK growth and financial markets. The pound will crystallize investor fears and be subject to high volatility.

Aline Goupil-Raguénès

Market review

Renewed lockdown risks

The health situation triggers profit-taking on equities, a fall in rates and a plunge in the euro.

The return of the Covid threat caused a sharp pullback in stock prices during last Friday's session. The deterioration of the sanitary situation is obvious in Europe. Northern and Eastern European countries are facing a sharp rise in cases. An immediate 22-day lockdown has been imposed in Austria. Germany could follow. Growth in the fourth quarter will likely be revised down. Investors are thus finding a reason to take profits after a 10% gain in the Euro Stoxx 50 since the October 4 close, especially as this session was marked by the expiration of derivative products. The euro, down sharply since the end of May, sank below $ 1.13.Given the absence of reaction from the ECB, the euro is becoming a funding currency for carry trades, much like the Japanese yen. The dollar is stronger. As is often the case during downturns, the US markets proved more resilient thanks to the downward adjustment in long bond yields. European banks are suffering from the Bund plunge below -0.30%. The fall in long-term yields squeezes breakeven inflation, as oil, below $ 80, prices in lockdown measures. The potential use of strategic petroleum reserves mentioned in the United States and in China also contributed to the drop in crude oil prices.

Budget negotiations are in standstill in the United States. The Manchin / Sinema duo is calling the shots as regards Biden’s plan, or even Lael Brainard’s bid for Fed chair. The $ 1,750 billion plan includes questionable financing ($ 400 billion expected from tax evasion reduction…) already criticized by the CBO. At the same time, concerns persist in Eastern Europe. Sanctions against Russia are being considered by Europe, which is also delaying the approbation of Nordstream 2. Russia and its ruble are teetering. Meanwhile Turkish monetary policy sent the Lira on a downward spiral. The political and health risks which could be heralding a correction thus seem to be piling up.

On the economic front, however, economic data releases point to strong growth in the United States. Manufacturing surveys (Empire, PhilFed) hint at a further acceleration in activity in November. The residential construction sector remains in good shape. Housing starts are still struggling to keep up with elevated building permits. Retail sales confirm the robustness of consumer spending on goods, from already high levels. Growth will likely be between 4% and 5% over the last three months of the year. In the UK, rising inflation remains a concern. Britain's CPI rose to 4.2% in October as the threat of activating Article 16 of the Northern Irish protocol would only add to pressure on supply chains.

Financial markets are tossed between fears of higher inflation and health and political risks. The sharp decline in long bond yields partially offset the earlier widening in breakeven inflation rates fueled by strong demand for inflation protection. Flows invested in inflation funds and final demand at the 10-year TIPS auction may have increased the long breakeven position, hence the magnitude of the correction. Breakeven inflation rates remain high, close to 2.7% at 10 years. The real 10-year yield nonetheless is still a paltry -1.14%. In the euro zone, the ECB is reluctant to act in the face of inflation above 4%. Christine Lagarde rules out monetary tightening in 2022. The accelerated decline in the euro, however, reinforces inflation risks. At the same time, tensions persist in the euro repo market. The end of the year is trading at very negative rates about -7% due to the collateral shortage caused, among other factors, by quantitative easing. Bills maturing before December 31, including peripherals, are quoted below -0.7% yields. The ECB changed its collateral rules for its securities lending facility to recycle excess liquidity (and reduce securities-for-securities lending). This is a similar phenomenon to what we saw in the US with the extensive use of the Fed's reverse repo facility. Euro swap spreads are significantly higher than a month ago. The 10-year is trading at 47bp. The Bund plunges below -0.30% at the end of the week, even pushing the 30-year German bond briefly into negative territory, but this acceleration had no impact on euro sovereign spreads. The Italian 10-year spread is indeed unchanged at 121bp. The primary bond market was not very active, with some tapping of existing bonds. A few euro area agencies have placed green bonds with uneven success.

The credit market is lackluster partly because of the tensions in swap spreads. The balance of flows is less favorable despite ongoing steady purchases by the ECB (5-6 billion euros net per month). The average credit spread is up towards 98bp against Bunds. Corporate bond issuance reached € 15 billion this week, including € 7.5 billion in financials. Note that 60% of November issues are now trading wider. European high yield spreads widened by around 9bp last week but the previous widening had made investors more comfortable regarding valuations in the speculative-grade segment.

The US stock market appears unsinkable, albeit higher daily volatility. The Nasdaq immediately resumed its bullish run after the T-note downshifted towards 1.5% last Friday. The Covid risks logically weigh on European stocks, in particular on airline stocks. Banks clearly suffer from the pullback in bond yields. In turn, secular growth (Technology, Pharmacy) keep outperforming.

Axel Botte

Global strategist

Main market indicators

G4 Government Bonds	22-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.74 %	-5	-10	-4
EUR Bunds 10y	-0.30%	-7	-19	+27
EUR Bunds 2s10s	44 bp	-2	-9	+31
USD Treasuries 2y	0.57 %	+6	+12	+45
USD Treasuries 10y	1.6 %	-2	-4	+68
USD Treasuries 2s10s	102 bp	-8	-16	+23
GBP Gilt 10y	0.94 %	-3	-21	+74
JPY JGB 10y	0.08 %	+1	-2	+5
€ Sovereign Spreads (10y)	**22-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	35 bp	-1	+1	+12
Italy	124 bp	+2	+14	+13
Spain	72 bp	-1	+9	+11
Inflation Break-evens (10y)	**22-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	164 bp	+5	+13	-
USD TIPS	263 bp	-12	-1	+64
GBP Gilt Index-Linked	409 bp	+2	-10	+109
EUR Credit Indices	**22-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	98 bp	+7	+11	+6
EUR Agencies OAS	49 bp	+1	+6	+8
EUR Securitized - Covered OAS	50 bp	0	+11	+18
EUR Pan-European High Yield OAS	324 bp	+6	+9	-34
EUR/USD CDS Indices 5y	**22-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	50 bp	+1	0	+2
iTraxx Crossover	253 bp	+4	-6	+11
CDX IG	51 bp	+1	0	+1
CDX High Yield	298 bp	+3	-2	+5
Emerging Markets	**22-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	361 bp	+9	+5	+9
Currencies	**22-Nov-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.126	-0.91	-3.26	-7.79
GBP/USD	$1.342	+0.01	-2.45	-1.84
USD/JPY	¥114.77	-0.57	-1.11	-10.04
Commodity Futures	**22-Nov-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$80.0	-$2.0	-$4.6	$29.4
Gold	$1 816.4	-$46.5	$23.7	-$82.0
Equity Market Indices	**22-Nov-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 729	0.99	4.05	25.90
EuroStoxx 50	4 346	-0.92	3.75	22.33
CAC 40	7 117	-0.16	5.69	28.20
Nikkei 225	29 774	-0.01	3.36	8.49
Shanghai Composite	3 582	1.38	-0.01	3.14
VIX - Implied Volatility Index	17.62	6.85	14.19	-22.55

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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Natixis Investment Managers

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